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AUTHOR(S):

MOTOYAMA, Yoshihiko

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What the Recent Turmoil Over Asian Currencies Tells Us

by Yoshihiko MOTOYAMA*

Introduction

There exists currency turmoil throughout all East Asian countries. It started from speculating Thai Baht in July 1997 and now is having an influence on Korean, Hong Kong and Japanese currencies. The story of this turmoil tells us the real nature of the recent changing East Asian world. Does this reflect a sign of the end of an age when East Asian economic planners look for a huge amount of foreign capital to develop economies? We can anticipate that there will occur intense competition to devalue the exchanges rates of the East Asian currencies.[1)]

China is the most important factor causing the drastic change in East Asia. China opened its door to the outside world only 19 years ago. Since that time, it has become an diamatic entrepreneurial powerhouse. The ensuing years of super-growth have left China with one of the world's biggest holders of foreign reserves and trade surplus, however, these facts produce the fear that China is becoming the second Japan.[2)]

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* Professor, Faculty of Economics, Kyoto University.

1) However, many economists still thinks that East Asia is growing steadly. Jeffrey D. Sachs is one such writer. In 1950, following decades of war and turmoil, Asia's share of world GDP was a mere 17%. In the past three decades, Asia finally caught the tail winds of global capitalism. Rapid economic growth has propelled Asia's share to around 40%. Moreover, Asia's economies will be producing more than half of the world's income sometime in the early decades of the 21st century", he says (Sachs, Jeffrey D., "Asia's Miracle is Alive and Well", *Time*, September 29, 1997, p. 40).

2) The ballooning current-account deficits of Southeast Asian countries over the past few years helped instigate the region's present currency crisis. However, behind the situation lies China. "Our sales have fallen 80% from two years ago," laments a Thai fabric wholesaler. Naturally, this has taken its toll on Thai textile producers. According to the Thai Textile Manufacturing Association, at least 100 Thai textile makers and garment makers have dropped out of the market last year. In recent years, China has improved the quality of its merchandise through joint ventures with foreign companies. In January 1994, the country also devalued its convertible currency, the yuan, by 33% against the U.S. dollar. As a result, Chinese products began to supplant their Southeast Asian equivalents around the world. The trend was not confined to textiles and other traditional export sectors. Haier Group Co. of Shandong Province and Guangdong Kelong Electrical Holding Co. of Guangdong Province — two major Chinese makers of consumer electronics — turned to exports as a way to offset oversupply conditions at home. Market participants say history has shown that there is often a lag of about two years between the time a currency loses value and the time when the loss starts to have a real impact on trade. China allowed its currency to depreciate in January 1994 in order to boost the strength of its exports. As a result, Chinese exports are growing, while export growth is slowing in Thailand and

(Continued)

I Shortage of Money for Financing World Growth

World-wide funds running around the globe is growing. About $1.5 trillion is now held in international equity portfolios. Even pension funds in the industrial countries which were traditionally cautious investors are looking for overseas opportunities to meet their steep funding obligations. Also, the need among developing nations for infrastructure is immense for the next decade at $1 trillion.

Nevertheless, money flowing into the productive basis could be shortage because of its high volatility. About three years ago, Business Week had already pointed out the possibility of capital shortage in financing world growth. Fast developing regions, such as Latin America and East Asia, have been absorbing more than $140 billion annually that is triple the amount of capital they absorbed in the late 1980s. Also since the fall of the Berlin Wall in 1989, the formerly communist nations of Eastern and Central Europe have been labouring to produce an attractive investment environment. These region could easily absorb up to $500 billion (*Business Week*, October. 3, 1994, p. 42).

Though the world faces an accelerating demand for capital that is unprecedented, nowadays, capital tends to fly away easilier and swiftlier from the country which was the central planning one. In additon, Japanese investors have virtually disappeared from the global stage. After playing a leading role as world financers during the 1980s, today's Japan inwardly focuses on repairing its damaged financial system. Ever since 1991, the outflows of long-term capital from Japan have shrunk to just one-tenth of their 1980s peak of $137 billion. As a result, the intense competition for capital will result in higher interest rates and increased currency volatility as investment demand outstrips the global supply of excess savings (*Business Week, ibid.*, p. 43).

On the one hand, a large amount of the foreign capital is flowing into China, but on the other hand, huge quantity of the capital also has been flowing out of Southeast Asian countries. According to the report of the NRI (Nomura Research Institute), the volume of the capital drain from the four countries in Southeast Asia: Thailand, Philippine, Malaysia, and Indonesia is estimated $22 billion in 1997 (*Nippon Keizai Shinbun*, 1997. 8. 30). IIF, the subsidiary of the World Bank, reported that the net private foreign capital inflow into the East Asia would diminish in 1997 by 25% (*Nippon Keizai Shinbun*, 1997. 9. 11).

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other members of the Association of Southeast Asian Nations (ASEAN) that linked their currencies to the dollar (Goto, Takuhiko, "China weaves export success", *The Nikkei Weekly*, September 29, 1997, p. 23). The volume of export from China to North America rose by 29% in the first half of the year in 1997 than the previous year, though that of Thailand rose only 4%. Sharp Co. Ltd. drastically shifts its outsoucing from the Southeast Asia to China because of its low costs (*Nippon Keizai Shinbun*, 1997. 9. 10).

II Lessons from the Turmoil over the Thai Baht

Thai Prime Minister Chavalit is to be blamed for delaying the timing of the devaluation of the Baht consciousnessly in order to save his favourite big companies. Many companies have been borrowing foreign money without any hedging and Chavalit has poured huge amount of official money to them prior to the day of the Baht's devaluation. Thai Central Bank has continued to lend money without any qualification to financial institutions with the outcome being a disaster. The total amount of such money poured into 58 nonbanks now put under suspension has reached Bt43 billion which was said to be poured into estate agents which suffered from being short of money (*Nippon Keizai Shinbun*, 1997. 8. 24). Even some high government officials were said to have speculated using the Baht. The currency turmoil in Thailand is not only due to unskilled money managing techniques but also due to malignant political habitude of this country (*Nippon Keizai Shinbun*, 1997. 9. 11).

Thailand has been praised for its openness to foreign investment. The accessibility of its domestic market has been widely held up as an example to other developing countries. However, as one of the biggest mistakes, the Thai government has raised domestic interest rates high to defend the Baht's pegged exchange rate at a time when exports were decreasing and the current account deficit began widening. This encouraged Thai financial institutions and large corporations to borrow foreign currency at low interest rates in order to fund their domestic investments. Thai banks and finance companies raised funds in overseas markets from 2 to 3% interest a year and then lent money to Thai firms at domestic interest rates of more than 15% a year.

At present, 21 Japanese banks are operating in Thailand, and their credit balances were $37 billion in July 1997, 30 to 40% of Thailand's total debt which was estimated to be about $90 billion. Many Japanese banks which have no branch office in Thailand have been financing via non-banks in Thailand. However, they did not advance for long-term financing. The amount of Thai's short-term debt from Japanese banks which was to be repaid within a year was $15 billion or so.[3)]

Despite large foreign capital inflows, to make matters worse, much of these investments went into Bangkok's overheated property market. When a serious mis-

3) The greatest cumulative amount of Japanese direct investments to Asia in 1995 was that to Indonesia, $18.6 billion. They invested $15 billion in Hong Kong, $13.2 billion in China, and $10.6 billion in Singapore. That of Thailand was the fifth in Asia, $8.4 billion, and $6.9 billion in Malaysia, $5.7 billion in Korea, $4.4 billion in Taiwan, $3.5 billion in Philippine. Japan is the greaest exporter to Thailand and the second biggest importer next to the U.S. Japanese direct investments to Thailand have increased since 1994 and 72.5% more in 1995 amounting to Bt243.1 billion. Total Japanese banking loans to the East Asia exceed $120 billion and the share of Japan's export to this area is about 40%. However, the export volume of Japan to Thailand in July 1997 decreased by 14.6% of that of the previous year. As for the mutual funds in the U.S., $5.6 billion flowed into Asian stock markets in 1993 when the boom prevailed in these emerging markets. But in 1997 $2.1 billion flowed out from these markets until the middle of August (*Nippon Keizai Shinbun*, 1997. 9. 8).

match between supply and demand in the capital's property market occurred in 1996, prices of offices and condominiums dropped drastically. Also, it triggered a financial crisis that exerted strong pressure on the Baht. On July 2, this pressure forced the Thai government to abandon its pegged exchange rate system. However, the government has continued to maintain high domestic interest rates to prevent the currency from being devalued.

The sharp depreciation of the Thai Baht has made many Thai banks and finance companies scramble for new capital to cover their increased loan risks. The Baht depreciation has also forced many of bank's corporate customers to default on their foreign currency loans. In addition, the loan defaults could greatly push up the amount of non-performing loans (NPLs) assets of banks and finance companies. Thai commercial banks' non-performing loans are said to have risen to Bt560 billion ($19.31 billion), equivalent to 14% of all outstanding loans.

Thai finance companies are worse than the banks because of their more aggressive lending policies. The finance companies' bad or doubtful loans will rise to Bt440 billion, or 30% of their total loan portfolios. That would bring the combined non-performing loans to 20%, or Bt1.1 trillion, of Thailand's (1996) gross domestic product (GDP).[4)]

According to the July 15, 1997 Goldman Sachs (Asia) report, in the worst case scenario, the devaluation of the Baht threatens to push NPLs to 35% of GDP, on the other hand, in the best case scenario would see NPLs reach 26% of GDP. By comparison, during the worst of the Mexican currency crisis in 1994, the Mexican NPLs were at 18% of GDP. So the Thai situation is much worse than Mexico's in terms of overall debt held by businesses. The ratio of total loans to GDP for Thailand

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4) In the columns of advertisements in the Times, October 6, 1997, the message about Thailand's decision to accept an IMF — imposed recovery plan were announced by the Thailand Board of Investment, the Department of Export Promotion, The Bank of Thailand, and the Tourism Authority of Thailand. The messages started by saying, "Painful is the word to describe what happened to Thailand's economy this past year", and expressed Thai Government's resolve to accept the IMF plan. "On August 5, our Government finally decided not to go it alone, and accepted an IMF — imposed recovery plan in exchange for a loan package. In the days ahead, the Thai people will share the pain caused by the IMF 'medicine', but will emerge stronger for it" (p. 7). The message confessed about the circumstances in July and August, 1997, and explained the details of the IMF plan. "By early August, it was apparent the Government had no choice but to seek emergency aid from the IMF. The IMF recommended strong medicine, packaged in a comprehensive standby credit and recovery plan. That plan was approved by the Thai Cabinet on August 5, and by the IMF itself on August 20". The plan includes a consortium of loans valued at $16.7 billion. However, this is no simple handout; the IMF has required Thailand to abide by stringent rules if recovery is to have a chance. The Government said, "the IMF plan is bitter medicine indeed for our once highflying economy. It includes a VAT increase from 7 to 10%, to raise revenue; a reduction of the current account deficit from 8% of GDP in 1996 to 5% in 1997 and 3% in 1998. Meanwhile, inflation must be kept at 8-9%, and the economic growth rate maintained at a minimum of 23%. Moreover, the IMF requires that public spending be reduced except for essentials (e.g. public health, education, social welfare, infrastructure) and that the managed float of the Baht continue" (p. 9). The message ended with a call for foreign investments to Thailand often referred to as the Land of Smiles. The message explained, "Literally translated, Thailand means 'Land of the Free'"(p. 11).

was 140% at the end of 1996. Mexico's ratio stood at 45% during its crisis (*Asian Business*, August, p. 24).[5]

Thailand's bankruptcy laws have serious shortcomings. Under the current law, creditors should wait up to 20 years to seize assets. If a company goes bankrupt, its assets are frozen for 20 years (*Asian Business, ibid.*, p. 23).

There is hardly any positive effects coming from the devaluation of the Baht. The import content of Thai exports is about 40% of the total value, so manufacturing firms are vulnerable to higher costs of imported raw materials, parts and production machineries. Labour-intensive manufacturers will be especially vulnerable to the effect of the wage-cost pressures that are likely to develop following a depreciation. Typically, when there's a depreciation, cost-push pressures tend to arise. These pressures always occur regardless of whether there is a significant import content in the product or not. They are going to put severe pressure on wage demands. Meanwhile the Baht depreciation is hurting the labour-intensive industrial sectors in unexpected ways. The Thai shrimp farming industry, for example, has been hit by Japanese buyers' demands for a 10% price cut (*Asian Business, ibid.*, p. 23).[6]

The total foreign currency borrowings by the Thai corporate sector amount to about $67.5 billion. However, most Thai corporations have not hedged their foreign currency borrowings against foreign exchange risks largely because they did not ex-

5) Paul Krugman pointed out that something like the 1994-95 Mexican peso crisis could happen in developing countries with current-account deficit of more than 5% of GDP. Also, he thinks that the epidemic of "bahtulism" sweeping across Asia is by no means the first such outbreak in modern times. "Even if we exclude the currency speculation that brought down the Bretton Woods system in 1971-73, or the attacks on the European Monetary System in 1992-93", he says, "the current financial uproar in Asia strongly resembles both the 'tequila' crisis that followed Mexico's 1994 devaluation and the collapse of bank lending that precipitated the 1982 Latin debt crisis". He understands the two crises were caused by the uncritical enthusiasm by international investors (banks in the late 1970s, mainly mutual funds in the early 1990s). However, stories appear after that. Though Latin America's debt situation in 1982 was not really severe, there followed seven lean years of economic stagnation, during which the debtor countries remained effectively excluded from world capital markets. In the 1990s, by contrast, the crisis was terrible but short-lived: Over the past year, Mexico's economy has grown more than 8%. What made the difference was the creditors' confidence in debtors' government behavior. In the 1980s, creditors did not have such confidence, and the relationship between the debtors and their creditors was politicized. Moreover, when the second crisis struck, Latin leaders were wise enough not to look for someone to blame but to try to restore confidence. Krugman insists, "the return to normalcy may be delayed for a long time if leaders start looking for villains instead of solutions. Many Asian leaders doubtless understand this, but some, above all the Malaysian prime minister, apparently do not" (Krugman, P., "Latin Lessons for Asia", *Far Eastern Economic Review*, September 25, 1997, p. 34).

6) To help growth in the next generation, Thailand needs to improve its schools, where Thailand lags behind other East Asian economies. The country can no longer rely on cheap labour alone. Rising wages are making Thai manufacturers uncompetitive in labour-intensive industries such as shoes and textiles; Firms need to move up the ladder to higher-value products, such as consumer electronics and computer chips, as other East Asians have done. This is hampered by a shortage in skills. In 1993 only 40% of 14-year-olds attended school, compared with 60% in Malaysia (*The Economist*, May 24, 1997, p. 11).

pect the currency peg to drop in this way. Moreover, the lack of a long-term debt market in Baht makes hedging against foreign exchange risks prohibitively expensive. To use short-term hedges for long-term loans costs about 10% of the loan amount a year, so it was reasonable that they did not hedge.

For now, persistent high bank interest rates in Thailand have continued to impede economic growth. The Bank of Thailand raised bank interest rates by two percentage points in a defensive move before floating the currency. Over the next six to 12 months, interest rates are likely to climb. This is because the shift from a stable exchange rate system to a more volatile floating exchange rate environment increases the amount of risk. Investors need to seek more increased reward in the form of higher interest rates. Also, a drop in currency value will produce higher inflation, which makes it harder to reduce interest rates. Higher interest rates also causes corporate profits to shrink at a time when many companies are already suffering from painful foreign exchange debt repayments that have swollen due to the devaluation.

The move to freer exchange rate policies tend to lead to the so-called 'competitive devaluations'. The Baht devaluation led to sizable losses among Thai corporations with high foreign exchange debts. To make good on those foreign debt obligations, many Thai companies have had to trim their profit margins to boost the competitiveness of their products in overseas markets. This puts pressure on exports from other Southeast Asian countries and erodes corporate earnings there. This, in turn, will put pressure on the currencies of those countries (*Asian Business, ibid.*, p. 27).

III The Changed Economic Environment in Asia

This is the time when we should acknowledge that the world has changed. For many Southeast Asian corporations, cost, risk and uncertainty have become the keywords of the currency drama. After the Thai Baht was cut down from its US dollar-led peg, investors turned on the Philippines, and then Malaysia, forcing central bankers to let currencies slide down from the carefully managed levels. Investors seem to have a belief that weakness in the economy will lead to a weakness in the currency (Geoge Soros' saying. *Business Week*, October 3, 1994, p. 46). They thought that Malaysia and the Philippines had also a big problem with bank loans poured into overheating property markets, one of the key components behind Thailand's economic sufferings.

The week of August 25, 1997, was the most brutal one in decades. Malaysia's government attempted to stabilize its injured stock market by limiting short selling by foreign investors. However, the wave of selling felt from Manila spread to Hong Kong. The Bank of Indonesia August 18 decision to raise treasury rates to 30% was to attract investors to hold rupiah, and to prevent the nation's currency from falling further. The Kuala Lumpur, Bangkok, and Manila Bourses plunged nearly 40% over a couple of months. They are headed for a possible recession themselves.

In facts, things are coming to a crisis in the Southeast Asia. A decisive change in the psychology of Southeast Asia has occurred. Not long ago, the economies of this region seemed unstoppable. Today, slower growth and vulnerability to global market forces are common throughout this area. Global investors are astonished to see how the region's governments had been unprepared for this crisis. Now it is no longer easy to boost exports with foreign investment and cheap labor combined and to spend the money freely on government projects of questionable worth. The pressure from China has been increasingly growing. Its exports are expected to increase by 25% in 1997, while Thai exports will rise less than 4%. Much of that is the result of China's growing global market share of garments, shoes, and toys but also reflects China's rise as a cheap manufacturing base for electronics, telecommunications equipment and machinery.

Proton Berhad, Malaysia's protected national carmaker, already plans to cut costs by 30% over the next three years. However, as it still heavily depends on imported parts that now are more expensive, it will have to become even more aggressive. Thailand's Siam Cement Co. wrote off $1 billion in foreign exchange losses. TelecomAsia Corp. has more than $850 million in foreign-denominated debt. All of it was unhedged, and should be repaid over the next 10 years (*Business Week*, September 15, 1997, p. 20).

The slowdown in Southeast Asian growth will hit many multinationals as well. General Motors has poured $750 million into a new car plant in Thailand at a time when demand was beginning to fall. Hong Kong-based First Pacific, a conglomerate in telecoms and property across Asia, will have a $20 million decline in profits this year.

In the Philippines, three-month rates rose to 19% as a result of the Central Bank's attempt to defend the Peso. Its stock market plunged as liquidity dried up and investors feared that corporate earnings would take a huge fall. A recession is coming if the central bankers do not stop it. In fact interest-rate hikes are crude weapons for preventing currency declines.

Unlike in the era of galloping growth, today's Asian companies in a slow growth climate need fuller financial disclosures and more transparency to restore the foreign investors' confidence. In Malaysia, the fears that the balance sheets of top banks and conglomerates are false is one reason investors are bailing out. For example, the $162 million Renong Berhad, a diversified conglomerate, has raised more than $1 billion in loans offshore. However, that sum does not appear in its books (*Business Week, ibid.*, p. 21).

Mahathir has denounced foreign investors. He blasted the IMF and called currency speculators "international criminals." But Mahathir's August 28 decision to curtail short selling by foreign investors, whom he blamed for the steep fall in Malaysian share prices, increased speculation. Then, Mahathir directed state-managed pension funds to buy local equities. Against such intervention, Malaysian fund managers pushed the Kuala Lumpur index to a four-year low of 751 (*Business*

Week, ibid., p. 21).[7)]

While all attention is being given to Southeast Asia, the situation in South Korea and Japan has become worse. Korea's foreign debt towers 3.5 times above its foreign reserves. Five conglomerates slipped into bankruptcy in 1997. The eighth-largest chaebol, Kia Group, and other chaebols, including Ssangyoung, Hanwha, and Haitai, are under strain as their cash flows worsen. The Won has been tumbling, and could tumble even further in the future. Korean economy is still far from hitting bottom.

Banks lost $13 billion due to failing chaebol, equivalent to 60% of their combined capital. Ten of 25 Korean commercial banks showed losses in the first half of 1997. Korea First Bank made a stunning $395 million loss as a result of chaebol failures.

The Korean Won dropped to a record low of 910 to the U.S. dollar in late August 1997 before the central bank struggled to bring it back to 900 on Sept. 3. To defend the Won, the Bank of Korea used $3 billion of its foreign reserves. The Won's decline, down 8% this year, caused a decrease in profits. Hyndai's car and electronics units lost $180 million in the first half of 1997 (*Business Week*, September 15, 1997, p. 21).

On the other hand, thanks to tax hikes and tighter government spending imposed by Japanese Prime Minister Ryutaro Hashimoto in April, weak consumer spending and falling industrial production have the economy decelerating once more. With growth unlikely to exceed 1.7% this fiscal year, the benchmark Nikkei index has been falling since its June high. Now, with the turmoil in the Southeast Asia, Japan faces new uncertainties over its economy.

Japanese manufacturers, for a decade, have been establishing production bases in the Southeast Asia to profit from the cheap labor and fast-growing consumer markets. Japanese exports to this region share about 44% of all her exports. Also, Japanese multinationals' Asia- based operations generated 40% of their offshore profits in 1996. Many Japanese companies have tried to make suppliers set up shops in this region and to create vast procurement nets of local partners there.

However, Japan's companies feel that this strategy is more and more ineffective. The slower growth in Southeast Asia means less demand for the Japanese pro-

7) But even businessmen in Kuala Lumpur, traditionally among Mahathir's greatest fans, fear his unorthodox approach might now bring political uncertainty and financial disaster. When, in August 1997, he responded to the slump in the stock-market by introducing a ban on certain types of trading, the market fell sharply, and the ban had to be lifted. Mahathir tends to see apocalyptic warnings of a Thai-style catastrophe as the prophecies of international conspirators bent on thwarting Malaysia's modernisation, and on subverting his authoritarian style of rule. He is not alone in Southeast Asia in blaming foreigners, but in Thailand, the Philippines and Indonesia such views are more tactfully expressed. Also, when, at the meetings of the last week of September, he made his, by now familiar, attack on currency speculators, notably America's George Soros, with a threat to ban dealing in the Malaysian currency, the ringgit, for purposes other than trade. When the foreign exchanges opened two days later, the ringgit predictably fell to a new low record, some 19% lower against the dollar than it had been in early July (*The Economist*, September 27, 1997, p. 29).

ducts such as construction equipment and machine tools which share roughly 60% of Japan's exports to this region. Moreover, the currency devaluation also means that consumers in Thailand, Malaysia, and elsewhere find it difficult to buy the TVs, computers, and other goods that make up the rest of Japan's exports. Toyota Motor Corp. in Thailand began to reduce production by 20% in 1997. Honda Motor Co. and Nissan Motor Co. also made similar moves.[8)]

Things are more dangerous in the banking sector. Japanese banks' lending exposure to the Southeast Asian companies is three times more than that of their U.S. counterparts. The region takes up some 70%, or $120 billion, of Japanese lenders' foreign-loan portfolio. Also, if regional borrowers start to default, it could add to the heavy problems of Japanese banks are facing, which are still burdened with $236 billion in bad loans for their own market. Such defaults in the Southeast Asia could surely delay a much-needed improvement in the Japanese lenders' balance sheets (*Business Week*, September 15, 1997, p. 22).[9)]

IV Increasing Fears of Huge Capital Migration from Southeast Asia to China

The Southeast Asia is now undergoing a sudden change in financial situations due to the new financial opportunities in China, which are attracting huge foreign companies. GE Capital Corp. got an equity stake in the $250 billion Zhabei power plant near Shanghai, which is the first Chinese power plant to be financed entirely by the private sector without any government guarantee. In addition, in May 1997, GE Capital also got permission to open a finance company which is the China's first wholly owned foreign one based in Shanghai. It will be able to lend money for everything to any foreign company. Other giant investment funds backed by American International Group, Peregrine Investment Holdings and New World Development are pouring billions of dollars into road, port, and bridge projects in China (*Business Week*, September 29, 1997, p. 43).

Moreover, it is not a surprise that the World Bank is a big China booster.

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8) Efforts to establish the production basis in East Asia on the part of the Japanese companies were payed since the Plaza Agreement that the Yen should appreciate against the U.S. Dollar. At that time, Japan's large trade surplus with the U.S., nearly $50 billion in 1984, was simply too large to ignore. Japan's global trade surplus, $61.6 billion in Japan fiscal year 1985, was only $12 billion above the $50 billion surplus with the U.S. Ambassador to Japan at that time warned that it was a burden on the world trade system, and if it would continue to grow it would threaten a breakdown in that system (Masumi Muramatsu, Mansfield Speech, Simul Academy, 1987, p. 10). Since then, high valued Yen drove many Japanese compnies to East Asia to produce their goods cheaply.

9) Japanese banks lend more in Hong Kong than in any other Asian economy beyond Japan. According to the Nikkei Weekly, at the end of 1996 Japanese banks had $87.4 billion in outstanding loans to Hong Kong companies. Contrast that with the $37.5 billion in loans extended by Japanese banks in Thailand. Japanese banks make 50-60% of their loans in Hong Kong to real-estate developers and local businesses, 20-30% to mainland Chinese companies and public agencies, and the remainder to Japanese companies in Hong Kong. So, the recent volatility in Hong Kong's economy, traditionally one of the most stable in Asia, has shaken investors and exposed Japan's vulnerable financial institutions (Masato Ishizawa, 'Investors running from risk', *The Nikkei Weekly*, Nov. 3. 1997, p. 19).

Now, China is the bank's biggest customer. The bank has recently decided to lend China $2.8 billion more, added to the total of $28 billion in China to build dams. China already attracted $42 billion foreign investment in 1996 and has $121 billion in currency reserves, not including Hong Kong's own $80 billion.

The World Bank estimates China needs $600 billion to develop its projects. However, the bank does not think that huge amount can be met by public financing within China. The bank believes that China needs a reasonable financial system to facilitate foreign investment. Also, the World Bank is bringing in innovative financial techniques to deal with privately financed projects. For example, China signed a $700 million agreement in September 1997 with a consortium headed by the power utility Electricite de France. China will let the consortium build and operate a power station in Laibin. Only after 15 years, the Chinese government will be able to assume ownership. This technique is common in developing nations, but it is the first time for China to do this.

The International Finance Corp. (IFC), the arm of the World Bank that lends to private companies, is backing the emergence of a privately owned financial service industry in China and trying to expand lending to smaller companies. It is also trying to develop the first domestic bond rating agency in China (*Business Week*, September 29, 1997, p. 46).

Perhaps the World Bank's great favour to China's reforms derives from its philosophy of a market-oriented economy. It does not recognise the other possibility of a non-market policy. On September 11, 1997, the World Bank warned that because in Southeast Asia lenders and borrowers are often in relation of conglutination, financial systems are very fragile and need to be changed into much market-oriented ones. It also said that the market would loose confidence in such uncleaned systems in this region, and as a result a large quantity of foreign capital would flow out of this region into the other regions which have a more functional market-oriented economy (*Nippon Keizai Shinbun*, 1997. 9. 12).[10)]

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10) Paul Krugman wrote in Time that the recent crises proves there's nothing superior about Asian values. He expressed his surprise at the mood of the executives from the multinational corporations then attending the regional conference held in Mexico in 1993. He said, "the executives were giddily upbeat; they saw nothing but boundless opportunities in a region enjoying unprecedented growth and transformation. They were in no mood to listen to concerns about productivity growth that did not seem to be as high as advertised, about trade deficits, about a worrisome tendency to borrow abroad and invest the money in speculative projects. In retrospect it seems almost incredible that neither governments nor investors took the 'tequila' crisis that engulfed Latin America 20 months later as a warning for Asia". And then he warned, "Asians had and have a right to be proud of what they have achieved. The doctrine of Asian exceptionalism, however, turns out to have been not merely silly, but dangerous. Partly this was because too many investors, domestic and foreign, took it as an excuse to believe that the good times could just keep on rolling — in particular, that the overheated Southeast Asian boom of the mid-90s, which drove real estate prices and trade deficits to what should have been seen as clearly unsustainable heights, could continue without limit" (Krugman, Paul, "Wrong, It Never Existed", *Time*, September 29, 1997, p. 41).

Conclusion

I do not think Malaysia's Prime Minister Mahathir's denouncement of global investors is wrong. Thailand's Finance Minister Thanong at that time also said that it was the failure to liberalize financial system too fast and make Thai economy dependent on foreign short-term loans too quickly when he came to Tokyo to call for relief funds in July 1997.

Thailand set up an offshore monetary market as a symbol of liberalization of the financial system in 1993. Through that market, a huge amount of foreign capital flowed in, and that amount was far larger than the government expected. However, Thai economy is not big enough to absorb such a large amount of capital. So much of capital was spent on the property market and the so-called bubble economy came into being. Foreign capital rushed in hurridly and fled away frightening fashion. They did not think about the positive role they could have played in Thailand. They wanted only instant reward. I do not believe that their flattering behaviour represents a reasonable economic movement. I dare to say they are no more capitalist than the "paparazzi".

The Prime Minister of Malaysia believes himself to be a victim of the capricious currency markets. In a speech during the opening weekend of the World Bank/IMF meeting in Hong Kong, he painted a vivid conspiracy theory in which Western bankers and governments had done their best to knock off Malaysia. However, when they opened on Monday, the markets in Kuala Lumpur promptly continued their late-summer collapse.

Still, Mahathir's speech had some resonance in the region, given the brutal economic battering it has taken of late. The emotional urge to subdue the bloodless speculators and do something to restore the flagging East Asian economic miracle that once existed. That is hardly surprising — in part because Mahathir's conviction that the countries in Southeast Asia are victims is not entirely wrong. By effectively linking their currencies to the U.S. dollar, nations like Malaysia and Thailand became bit players in a much bigger game. They thought the dollar peg would give them some monetary stability. However, that is not the main reason for recent trouble in Southeast Asia. It comes from the changed strategies of the U.S. and Japan toward China.[11]

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11) Mahathir alleged that Mr Soros is motivated by the political agenda of his personal foundation, which supports efforts to build "open societies" in the former Soviet Union and elsewhere. The Soros Foundation has taken an interest in Myanmar, which is run by a repressive military regime, and Mr Soros disapproves of ASEAN'S controversial decision to admit Myanmar to membership on July 23, 1997. There is, Stanley Druckenmiller (the Soros Fund's chief investment officer) who insists thatthere is no connection between Soros Fund Management's initiatives to make money and the foundation's attempts to distribute it. Dr Mahathir, however, seems to resent both activities, which makes Mr Soros a politically expedient target. Some historic grudges may also be at work. Malaysia's Central Bank and the Soros funds clashed in 1993. In addition, the previous September, the Central Bank, Bank Negara, lost a fortune betting on sterling when the British currency fell out of the Euro-
(Continued)

Trade and capital flows within Asia and across the Pacific are dominated by Japan and the United States. The dollar/yen exchange rate has become the subject of intense political interest but has rarely been stable. Twice since the mid-1980s, the exchange rate has shifted drastically. When Southeast Asian countries tied up with the dollar, it was a weak currency, and for a time it suited them in a beneficial way. Exports (many from transplanted Japanese factories in search of lower costs) boomed, overall growth rates surged and that virtuous combination attracted enormous amounts of portfolio investments from the West.

Regional governments forgot the central fact about markets: they often tumble excessively. Moving in one direction or the other, they tended to shift the value of a currency or commodity beyond the bounds that are set by underlying economic fundamentals. Also, speculators tried to appear as a friend, helping the other out. They hop onto what may be an economically rational move in the market and drove it to extremes. That was seen in the OPEC — driven oil "crisis" of the late 1970s. The price of a barrel of oil skyrocketed far beyond anything that was economically rational, driving up interest rates. Then, on the way down, the oil price simply collapsed, and by the late 1980s cities like Houston, Texas, came to look a lot like Bangkok, Thailand, and still does today, full of newly built offfice buildings that no one ever moves into.

What was once true of oil has also been true of the dollar. By 1995, the greenback had fallen to 78 against the yen. That was too low. So a correction was inevitable, and offficial nudges in Washington and Tokyo helped it along.[12)]

Today the dollar has strengthened to 120-50 percent swing in two years — and

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pean exchange-rate mechanism and was devalued. This is a move that is said to have made Mr Soros a fortune (*The Economist*, August 2, 1997, p. 62).

12) The Economist accurately gave an explanation on the speculation. According to that paper, hedge funds, such as Mr Soros's Quantum Fund, have been blamed for much of the financial turmoil in recent years. Mahathir told the annual meetings of the IMF and World Bank in Hong Kong that currency trading (beyond, he conceded, the level needed to finance trade) was "unnecessary, unproductive and immoral". The IMF estimates that hedge funds can mobilise between $600 billion and $1 trillion. Since Britain's problem in the 1960s, the volume of currency trading has burgeoned relative to trade. In 1995, $1.2 trillion of foreign exchange changed hands on a typical day. That is roughly 50 times the value of world trade in goods and services. In the early 1970s, prior to the liberalisation of the world's capital markets, the value of currency trading was only six times greater than the value of "real" trade. Currency trading is likely to use to bet against currencies and other assets, for example, selling acurrency forward in the hope that they can buy it back later at a cheaper rate. That is said to play an important role in providing liquidity in the market for foreign-exchange, helping to match buyers and sellers. However, it does not mean currency markets are perfect. Financial markets are vulnerable to "bubbles" and excess volatility. In such cases, prices move more than is warranted by the underlying factors investors supposed to reflect. Differences in countries' inflation rates and current-account deficits explain exchange-rate movements quite well in the long run, but in the shorter run currencies seem to disregard these fundamentals. For example, the dollar's fall from ¥260 in 1985 to ¥80 in 1995, and its subsequent rebound to around ¥120, cannot really be explained by the fundamentals. The problem is that all financial markets, from currencies to shares, are subject to waves of excessive optimism followed by excessive pessimism (*The Economist*, September 27, 1997, p. 93).

Southeast Asia, not surprisingly, got whiplashed. Exports slowed and current account deficits mounted. Under these circumstances, delinking from the dollar was inevitable. When two supertankers (U.S. and Japan) change their course, the little boats in between can take on water in a hurry if they do not get out of the way. However, too big swings in the part of Asian currencies should be prevented as soon as possible. To realize such a condition I believe it is necessary to estabilish a kind of Asia Fund is necessary.[13)]

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13) Japanese Finance Minister Hiroshi Mitsuzuka expressed support for a plan to establish a regional emergency fund to prevent currency crises in Asia. In a Nikkei interview on Sept. 23 Malaysian Finance Minister Anwar Ibrahim said the Asia Fund, expected to total $50-60 billion, will likely be set up by the end of this year by members of the Association of Southeast Asian Nations (ASEAN), Japan, China and South Korea, though China and South Korea have not yet made any official response to the request for them to join. Thai government spent some $20 billion to defend its currency. Therefore, the $50-60 billion fund be sufficient to prevent currency crises in Asia. If the fund is $50-60 billion, Japanese officials say Japan is expected to contribute a little less than $20 billion. Many hurdles must be cleared before the fund can be realized. The first is the need to win international support. The U.S., the largest contributor to the IMF, is also playing a role regarding the fund, although not a financial one. U.S.Treasury Secretary Robert Rubin said the U.S., Japan and ASEAN members will soon hold a new round of discussions on this issue. However, International Monetary Fund officials remain skeptical of the plan to form the so-called Asia Fund. The IMF has called the fund a mistake, saying it worries that a regional fund would undermine the functions of existing multilateral financial institutions. The IMF First Deputy Managing Director Stanley Fischer said, "We would be concerned about the establishment of an international body that would undercut conditions set by the IMF." Germany has already dismissed the idea, warning that the fund could encourage governments to rely on a safety net in times of trouble (Ishizawa, Masato, "Asia Bailout Fund Gets Key Ally in Finance Minister", *The Nikkei Weekly*, September 29, 1997, pp. 1, 23).

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Table 1 Trouble in Southeast Asia's Stock Markets (weekly close)

	Mar. 7, '97	Aug. 29, '97
Bangkok	bt 700	bt 500
Kuala Lumpur	rt 3300	rt 2000
Manila	ps 1250	ps 800
Jakarta	rs 700	rs 500

(Bloomberg Financial Markets. cited in *Business Week*, Sept. 15, '97, p. 19)

Table 2 Korea's Won per U.S.Dollar (weekly close)

Mar. 7, '97	Aug. 29, '97
870	905

(*ibid.*, p. 21)

Table 3 China's Economic Quandary (billions of dollars)

	'87	'91	'96
Merchandise Exports	30	60	170
GDP	300	420	800
Foreign Direct Investment	2	4	43
Hard-Currency Reserves	20	48	135

(*Business Week*, Sept. 29, '97, p. 42)

Table 4 Balance of Payments of Several Countries
(billions of dollars, ▲=deficit)

		current a/c	capital a/c	reserves	external debt	exports	GDP
Thailand	'90 '96	▲ 7.3 ▲ 14.7	9.1 18.0	13.3 38.6	28.1 78.5	23.1 55.7	85.6 182.6
Malaysia	'90 '96	▲ 0.8 ▲ 5.1	1.7 9.2	9.7 23.1	16.4 28.7	29.4 77.8	42.9 98.1
Indonesia	'90 '96	▲ 3.0 ▲ 7.7	4.5 11.0	7.4 18.2	69.9 (n.a.)	25.6 49.8	106.1 (n.a.)
Philippines	'90 '96	▲ 2.7 ▲ 5.2	2.1 9.2	0.9 10.0	30.6 (n.a.)	8.1 20.5	44.3 83.5
Korea	'90 '96	▲ 1.7 ▲ 23.7	2.9 17.2	14.8 33.2	31.7 102.0	65.0 129.7	253.7 484.8
Mexico	'93 '95	▲ 23.4 ▲ 29.4	33.7 15.8	25.1 6.3	118.0 133.7	30.2 34.5	403.2 421.7

(Data: Sakura Research Institute)

Table 5 Current Account Deficit Compared to GDP (%)

	Thailand	Malaysia	Indonesia	Philippines
'94	▲ 5.6	▲ 6.3	▲ 1.6	▲ 4.6
'95	▲ 8.1	▲ 8.5	▲ 3.5	▲ 2.7
'96	▲ 8.2	▲ 6.0	▲ 3.4	▲ 4.2

(Data: Dept. of Economic Planning, *Asian Economy 1997*)

Table 6 External Debt Ratio to GDP (%)

Thailand	Malaysia	Indonesia	Philippines	Singapore	Korea	Taiwan	China
43.0	29.3	48.4	50.2	0.0	21.0	9.5	14.3

(Data: *ibid.*)

Table 7 China as NO. 1

	Exports, 2nd Quarter, 1997 (billion dollars)	Export Growth from A Year Ago (%)	Net Foreign Investment, 1996 (billion dollars)	Average Hourly Wage, 1997 (dollars)
China	46.1	25	38.5	0.9 (Shanghai)
Hong Kong	47.8(a)	4	6.2(b)	7.3
Indonesia	13.1	7	5.3	1.8 (Jakarta)
Malaysia	19.7	▲ 0.2	3.3	4.6 (Kuala Lumpur)
Philippines	5.9	24	1.2	1.3 (Manila)
Singapore	32.1	4	2.0	5.2
Korea	35.8	9	▲ 1.6	6.2 (Seoul)
Taiwan	30.7	7	▲ 0.5	7.5 (Taipei)
Thailand	14.0	0.8	1.3	3.0 (Bangkok)

(a) includes large number of goods re-exported from China.
(b) 1995 figure. includes investment for China, via Hong Kong.
(Data: *Time*, Sept. 29, 1997, p. 39)